

those rate relationships and the permitted degree of price flexibility. Any final rule in this proceeding should accommodate these objectives.

Finally, the Commission asks for comment on whether a lower limit for pricing flexibility is really necessary.⁴² USTA believes that a pricing floor is not needed. Predatory pricing is not likely to occur because LECs under the incentive plan would generally utilize pricing flexibility to meet or approach the lower, non-predatory rates of price cap carriers.

4. The New Services Rule Should Not Require a Cost-Based Filing After 12 Months If the LEC Continues to Meet the De Minimis Test.

The Commission proposes that LECs subject to optional incentive regulation could introduce new services with a presumption of lawfulness if the anticipated earnings from the service are de minimis, i.e., they are less than 2% of the LEC's total operating revenues, and the rate for the service does not exceed the rate charged by the geographically closest price cap carrier.⁴³ Under the proposal, the LEC would be required to file rates for the

⁴² NPRM, ¶ 19.

⁴³ NPRM, ¶ 16. There is some confusion as to the new service de minimis test in so far as the text of the NPRM refers to "total operating revenues" while § 61.50(i) of the proposed rules references "total access revenues".

new service at the end of 12 months based on the historical costs for the service.⁴⁴

USTA supports a flexible new service standard, but believes that the Commission's proposal needs to be changed in several important respects if it is to meet its intended purpose of simplifying and reducing the regulatory burdens involved in new service introductions.⁴⁵ First, the Commission should not require a cost based filing within 12 months if the LEC continues to meet the de minimis revenue standard. Such a requirement would be burdensome, unnecessary and could frustrate new service introduction. So long as the Commission has a rate benchmark from a larger carrier, there is little chance that a new service rate of a LEC under the incentive plan would be excessive. Further, if the revenues remain de minimis, the rates charged would have no significant impact on the LEC's total revenue requirement.

Cost-based pricing of a new service could actually cause rates to increase and produce rate churn. This would be particularly true if the LEC provides a service with very low demand, such as a service provided to 1 or 2 customers. Cost based rates could also frustrate the competitive

⁴⁴ Id.

⁴⁵ See id.

efforts of a small LEC to price its new services at a level no higher than a neighboring large carrier.

Second, the Commission should change the de minimis test to include new services whose projected revenues will meet the 2% test, or will be less than \$200,000. This change is needed to facilitate new service introduction by very small companies for which the 2% standard would yield an unreasonably low threshold.

Finally, the rate benchmark for a new service should include any rate on file with the Commission for a comparable service offered by a price cap LEC, if such a service exists. Under the Commission's proposal, a holding company would be required to have company-specific rates for each affiliate. Moreover, a contiguous carrier may not always be offering the same service. USTA believes that this proposed change will help ensure that new service rates are reasonable, while avoiding the complexities of the Commission's proposal.⁴⁶

⁴⁶ The same new service rule under optional incentive regulation should apply to baseline regulation. See NPRM, ¶ 45.

**5. A LEC Should Not Have To Meet A Heavy
Burden In Order to Retarget to the Lower
End of the Earnings Range During the Two-
Year Period.**

The Commission requests "comment on whether companies electing participation in the incentive plan should retain the option of filing revisions within the two-year period."⁴⁷ The Commission suggests that it might require "a company seeking mid-term changes to bear a heavy burden of proving that cost changes render their current rates unreasonable."⁴⁸

USTA supports the Commission's proposal to allow LECs the option of filing tariff revisions within the two-year plan period. If revisions are necessary to retarget the LEC's rates to the lower earnings limit, however, the LEC should not be required to meet a "heavy burden" of proving that its current rates are unreasonable. Such a requirement would be inconsistent with the approach taken in the price cap proceeding where the Commission permitted LECs whose earnings were below the lower earnings limit, and whose rates were below the price cap index, to adjust upward to the limit, in order to "ensure that the LEC will remain healthy and able to provide needed services. . . ."⁴⁹ LECs

⁴⁷ NPRM, ¶ 10.

⁴⁸ Id.

⁴⁹ Second Report and Order, 5 FCC Rcd at 6802.

under optional incentive regulation should not have any higher burden in this regard than do price cap companies.⁵⁰

**6. The Service Quality Reporting Requirements
Are Unduly Burdensome for Smaller LECs.**

The Commission tentatively concludes that all carriers that participate under optional incentive regulation should file the same quarterly service quality information reports required of the price cap carriers.⁵¹ The Commission also proposes that incentive regulation LECs file the information contained in the annual price cap infrastructure reports, except that this information could be filed biennially.⁵²

USTA believes that LECs participating under optional incentive regulation will have a strong incentive to maintain a high level of service quality for their customers. It would be contrary to the LECs' financial interests to jeopardize their customer relationships by allowing service quality and network plant to deteriorate.

Nevertheless, USTA recognizes the Commission's concern for an additional level of customer assurance through

⁵⁰ In its proposal submitted to the Commission staff and placed on the record in this proceeding, USTA proposed the use of a rate adjustment factor to facilitate retargeting to the plan's earnings limits within the two-year period. USTA urges the Commission to implement USTA's proposed approach.

⁵¹ NPRM, ¶ 21.

⁵² Id.

periodic reporting of service quality. There is no need, however, for incentive regulation LECs to file the identical reports, and on the same quarterly intervals, as price cap carriers. The generally smaller size of LECs under incentive regulation would make such reporting burdensome. Further, in view of the differences between optional incentive regulation and price caps (in particular, the considerably lower earnings limits of optional incentive regulation), the incentive plan does not require the same service quality reporting as price caps. For these reasons, USTA proposes that carriers electing optional incentive regulation should file reports similar, but not identical, to the reports required of price cap LECs. These reports, which should be filed on an annual, not quarterly, basis, would include the following:

- a. installation interval reports, reflecting the percentage of service installations completed within carrier established intervals;
- b. repair interval reports, reflecting the average total number of hours to complete requested repairs;
- c. network blockage reports, reflecting the ratio of blocked call attempts to total attempts at the busy hour; and

- d. switch downtime reports, reflecting the amount of time during the reporting period that a switch is totally down.

This level of reporting should be more than adequate to permit the Commission to monitor service quality by LECs participating under optional incentive regulation.

7. Upon Leaving Optional Incentive Regulation, LECs Should Be Permitted to Reenter the NECA Traffic Sensitive Pool; Small Carriers Should Also Be Allowed Reentry to the Common Line Pool.

The Commission proposes that LECs participating in the incentive plan must remain in the plan for no less than two years.⁵³ If a carrier subsequently leaves the plan, the Commission states that the LEC must file rates pursuant to Section 61.38 on a company-specific basis, and cannot return to the incentive plan for at least four years.⁵⁴

USTA supports the Commission's proposal that LECs be permitted to leave optional incentive regulation subject to appropriate safeguards. Small and midsize companies require flexibility to leave the plan if changed circumstances would threaten their continued viability or otherwise be inconsistent with the interests of their customers. At the same time, the minimum two and four-year periods proposed by

⁵³ NPRM, ¶ 26.

⁵⁴ Id.

the Commission for plan participation and reentry, respectively, will help ensure that LECs do not game the process by switching back-and-forth between the filing options.

USTA is concerned, however, with the Commission's proposal that a LEC must file "company-specific" rates when it leaves incentive regulation.⁵⁵ The Commission should make clear that "company-specific" is not intended to deprive a group of affiliated telephone companies from filing a single tariff that is not an association tariff, as is now permitted under the Commission's rules.⁵⁶

Further, LECs leaving incentive regulation should be permitted to reenter, or enter for the first time, NECA's traffic sensitive pool. The Commission's current rules do not preclude carriers from reentering the voluntary traffic sensitive pool. Pool participation should not be prohibited merely because the carrier had been under optional incentive regulation. A requirement that the LEC cannot participate in the pool would be particularly severe in light of the Commission's proposal that the carrier cannot return to the

⁵⁵ Id. See id., Appendix A, § 61.50(d).

⁵⁶ See 47 CFR § 69.3(e). Upon ceasing participation in optional incentive regulation, a LEC should be permitted to combine affiliated study areas in the same manner as such areas were combined when the LEC initially participated in the plan.

plan for at least four years.⁵⁷ The no pooling requirement is also inconsistent with achieving the goal of pooling neutrality.

Finally, although reentry to the NECA common line pool is ordinarily not permitted, the Commission should allow such reentry for small telephone companies. Allowing small LECs to reenter both the NECA traffic sensitive and common line pools would mitigate part of the risk faced by these companies due to their higher revenue variability.⁵⁸ By allowing pool reentry, these LECs should be more willing to participate in optional plans in the first instance for both traffic sensitive and common line rates. To help ensure pool neutrality and to eliminate any chance of gaming, however, a carrier reentering the common line pool should be required to maintain its Long Term Support obligation.⁵⁹

**8. The Common Line Demand Adjustment Must
Share the Benefits of Demand Growth
Between the Carrier and its Customers.**

The Commission seeks comment on whether the optional incentive regulation plan should incorporate "the same

⁵⁷ See NPRM, ¶ 26.

⁵⁸ See NPRM, ¶ 24.

⁵⁹ For purposes of this proceeding, USTA would define small LECs as carriers with less than 50,000 access lines. This definition should ensure that a LEC reentering the common line pool would have no material impact on pool composition.

treatment of common line rates as for Section 61.39"⁶⁰
USTA believes that a carrier common line adjustment formula should be adopted for the incentive plan. For the reasons stated below, however, the formula proposed by the Commission for Section 61.39 should be rejected in favor of a demand adjustment that would equitably share the benefits of carrier common line demand growth between the LEC and its customers, and would recognize the common line cost growth experienced by non-price cap LECs.

It appears to USTA that application of the Commission's adjustment formula would result in ascribing the full benefit of growth in common line demand to the LECs' IXC customers and none to the LECs themselves. This result is contrary to the Commission's conclusion in the price cap proceeding "that an approximately equal, 50-50 division" would "strike the best balance" between attributing the benefits of common line demand growth to LEC productivity initiatives, on the one hand, and IXC efforts, on the other.⁶¹ At the very least, USTA believes that the common line demand adjustment under optional incentive regulation, and under the Section 61.39 filing option, should provide LECs with no less incentive to increase

⁶⁰ Erratum to NPRM, DA 92-1047, released July 29, 1992.

⁶¹ Second Report and Order, 5 FCC Rcd at 6795.

carrier common line productivity than afforded by the price cap plan.

To this end, USTA has proposed a carrier common line adjustment formula that would be applicable to both the incentive plan and Section 61.39. USTA's formula would allow LECs to recover their costs while sharing the benefits of carrier common line demand growth between IXC customers and LECs.

Because of inherent differences between the price cap plan and optional incentive regulation,⁶² the price cap demand adjustment formula is not appropriate for the optional incentive plan. Instead, USTA proposes to adjust for carrier common line demand growth by attributing the benefits of historical growth over an annual minutes-of-use (MOU) per line growth threshold equally to both customers and carriers. In determining carrier common line rates for the next biennial period, historic demand would be multiplied by one plus 1/2 of any historic growth in excess of an estimate of common line cost growth for companies

⁶² For example, unlike price caps, the incentive plan does not provide for the automatic recovery of annual inflationary cost increases.

eligible to elect the incentive plan, pursuant to the following formula:⁶³

$$CCL_{ADJ} = CCL_{HIST} * [1 + [(g-1.025)/2]]$$

Where CCL_{ADJ} is the adjusted CCL MOU demand for the next biennial period.

CCL_{HIST} is the historic CCL MOU demand.

g is the ratio, raised to the 1/3 power, of MOU per access line during the last year of the base period, to the MOU per access line during the first year of the previous base period.

The CCL rate would then be calculated as follows:

$$RATE_{CCL} = \frac{COST_{HIST}}{CCL_{ADJ}}$$

Where $COST_{HIST}$ is the historical test period carrier common line revenue requirement.

USTA urges the Commission to adopt this more equitable common line adjustment formula for both the incentive plan and Section 61.39, in place of the proposal set forth at ¶ 34 of the NPRM.

B. Baseline Rate-of-Return Regulation.

1. Prospective Ratemaking Is Fundamental to Baseline Regulation.

Non-price cap LECs, which do not elect optional incentive regulation or the Section 61.39 filing option, would continue to be regulated under what the NPRM refers to

⁶³ USTA estimates the common line cost growth to be 2.5% per year as shown in Attachment 1 to these Comments. No adjustment would be necessary where the historic demand growth does not exceed the MOU growth threshold.

as "baseline" rate-of-return regulation (i.e., regulation based on Section 61.38 tariff and Part 65 earnings requirements, and on the Part 69 access charge rules).⁶⁴ The Commission tentatively concludes that the level of detail required to support tariff filings under baseline regulation is excessive.⁶⁵ Accordingly, the Commission proposes to require baseline tariff filings every other year (rather than annually),⁶⁶ and seeks comment on whether baseline cost support could be developed from "simple extrapolations of historical costs and demand" or, alternatively, whether "it may be possible to require only historical costs to support certain rate elements, such as traffic sensitive rates."⁶⁷

USTA agrees that the level of cost support detail required under baseline regulation is excessive, particularly in view of the fact that the cost support requirements were developed primarily for the purpose of reviewing the tariff proposals of the largest carriers, most of which now participate under price cap regulation. In

⁶⁴ See NPRM, ¶¶ 38-40.

⁶⁵ Id. at ¶ 42.

⁶⁶ Id. at ¶ 43.

⁶⁷ Id. at ¶ 44. The Commission also seeks comment on the application to baseline regulation of streamlined procedures for the introduction of new services. USTA addresses this issue at Section II.A.4 above.

USTA's view, however, the proper solution is to simplify the Commission's tariff review plan (TRP) requirements. The Commission should under no circumstances abandon baseline regulation's reliance on prospective costs as the principal support for rate-of-return tariff filings.

The Commission's suggestion that historical data might be used to support certain tariff elements, or that prospective costs and demand might be derived through simple extrapolations, loses sight of the fact that the instant regulatory reform proposals are intended to represent a "continuum" of increasingly incentive-based regulatory options for small and midsize LECs.⁶⁸ As discussed below, the starting point of any continuum must be prospective rates for those LECs, and the NECA pools, whose circumstances make reliance on historical costs and demand, or even on simple extrapolations, unacceptable.⁶⁹

Reliance on historical costs and/or simple extrapolations will not allow baseline LECs and the NECA pools to account fully for future cost-intensive events, such as Signalling System # 7 and 800 data base implementation, state infrastructure requirements and

⁶⁸ See NPRM, ¶ 3.

⁶⁹ If a LEC wished to file rates based on historical costs, it could opt for a Section 61.39 filing or for the incentive regulation plan.

changes to the North American numbering plan. Even if baseline LECs were allowed to incorporate known and measurable changes into their historical-based rates (and there is nothing in the NPRM to suggest that the Commission contemplates including known and measurable changes in baseline regulation), a reasonable definition of known and measurable changes would likely preclude the inclusion of highly probable future cost and demand changes for which there is no objective confirmation (e.g., a written contract or work order) at the time of the tariff filing.

Moreover, utilizing historical costs and demand under baseline regulation would bias long-term earnings results against NECA pool members and other rate-of-return carriers. In some years, the pools and baseline LECs would achieve earnings results exceeding the authorized return level, and in other years they would achieve results that are less than the authorized level. Even with the Commission's proposed repeal of its automatic refund rule⁷⁰ in CC Docket No. 92-133,⁷¹ such results would make it impossible for the pools and LECs to meet their authorized return level over a period of years. Complaints could be filed for refunds during

⁷⁰ 47 CFR §§ 65.700-65.703.

⁷¹ Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, Notice of Proposed Rulemaking and Order (Rate-of-Return Notice), FCC 92-256, released July 14, 1992.

those periods when there were LEC or pool overearnings. In other periods, there would be no mechanism to recoup underearnings.⁷² This outcome would substantially increase the risks to LECs of baseline regulation.⁷³

Of course, the Section 61.39 filing option could produce the same bias toward underearnings since this option is based on historical costs. There is an important distinction, however, between baseline regulation and Section 61.39. Section 61.39 is optional and will be elected only by those LECs whose circumstances will not produce an underearnings bias (i.e., they expect stable costs and demand), or whose management believes that the balance of the risks involved does not outweigh the potential benefits afforded by the Section 61.39 filing

⁷² USTA questions whether this result would be consistent with the Court's decision in American Telephone and Telegraph Co. v. FCC, 836 F.2d 1386 (D.C. Cir. 1988). The bias toward underearnings could be mitigated depending on action the Commission might take on expanding the current earnings buffer zone. See Rate-of-Return Notice at ¶ 101, and discussion below at Section II.B.2.

⁷³ Even with rates based on prospective cost and demand data, there will be some periods in which there are overearnings, and some periods in which there are underearnings. With rates based on prospective data, however, there should be a closer correlation between the target return and actual results than could be achieved using historical data. (This would be particularly true during periods of changing cost and demand.) This closer correlation reduces period-to-period earnings variability and, thus, decreases the carriers' risk.

option.⁷⁴ In contrast, baseline regulation would be mandatory for those non-price cap LECs who do not otherwise elect the Section 61.39 filing option or the incentive plan. Such LECs, including the NECA pools, should not be forced into a historical filing mode on the first rung of the regulatory continuum.

Finally, USTA supports the Commission's proposal to allow baseline tariff filings every other year, so long as "[t]his would not limit carriers from filing more frequently."⁷⁵ Two-year filings would help to minimize administrative costs for both LECs and the Commission. Carriers and the NECA pools, however, must retain the right to file their access tariffs for a one-year filing period if they believe that a two-year cycle would not permit them to accurately reflect all prospective cost and demand changes. Further, LECs which do file two-year tariffs must retain the ability to make mid-course adjustments when appropriate.

2. The Commission Should Expand the Earnings Buffer Zone.

The Commission has asked parties to address enforcement issues in the CC Docket No. 92-133 proceeding,

⁷⁴ See discussion at Section II.C below.

⁷⁵ NPRM, ¶ 43.

supra.⁷⁶ USTA is constrained, however, to note the importance of earnings enforcement to any reform proposal for baseline regulation. In particular, regardless of whether the Commission repeals or revises the automatic refund rule in CC Docket No. 92-133, a LEC under baseline regulation should be allowed to earn up to 100 basis points above the authorized return before its rates are considered to be unreasonable. This change would provide flexibility for smaller rate-of-return LECs whose earnings tend to be volatile. It would also strengthen the incentive component of baseline regulation without introducing the problems associated with reliance on historical costs, or on cost and demand extrapolation as a substitute for true prospective data.⁷⁷

C. USTA Supports the Commission's Proposal to Extend the Section 61.39 Filing Option to Common Line.

The Commission tentatively concludes that its "goals of simplification, reduction of regulatory burdens, and assurance of reasonable rates, can be achieved by permitting eligible carriers to elect Section 61.39 rules for either traffic sensitive or both traffic sensitive and common line

⁷⁶ NPRM, ¶ 12, n. 11.

⁷⁷ As a streamlining measure, USTA also supports earnings enforcement only at the total interstate access level for rate-of-return companies.

rate development."⁷⁸ The Commission's proposal is consistent with USTA's request in its petition for rulemaking, filed April 11, 1989,⁷⁹ to expand the Section 61.39 rules to include common line. Subject to the comments below, USTA fully supports the Commission's proposal.

The Commission must adopt a carrier common line demand adjustment formula that equitably shares the benefits of common line demand growth between the LEC and its IXC customers. As discussed in Section II.A.8 above, the adjustment mechanism proposed by the Commission⁸⁰ appears to attribute all demand growth to the efforts of the IXCs. To correct this inequity, USTA recommends that the Commission prescribe for Section 61.39 the same adjustment formula that USTA has proposed for the optional incentive regulation plan.

Finally, the Commission states that cost support data for rates derived under Section 61.39 need not be filed with the Commission but should be retained by the LEC in case the Commission subsequently requests the data.⁸¹ Additionally, the data "would be made available to interexchange carrier

⁷⁸ NPRM, ¶ 35.

⁷⁹ RM-6768.

⁸⁰ Id. at ¶ 34.

⁸¹ Id. at ¶ 34, n. 18.

customers upon reasonable request."⁸² The Commission should make clear that a reasonable request by an IXC for cost support data is a request that is made during the applicable tariff review period.

III. CONCLUSION

It has been nearly two years since the Commission stated that it would initiate a proceeding to address regulatory reform issues important to small and midsize LECs. USTA supports the Commission's current efforts to fulfill that promise and to bring incentives, tariff streamlining and decreased regulatory burdens to the nearly 1,300 LECs that remain under rate-of-return regulation. USTA is concerned, however, that without several fundamental changes to the Commission's proposals, the benefits envisioned by the Commission will not be achieved, and many carriers, including those in the NECA pools, could be seriously harmed.

Of particular importance, the Commission must permit a LEC to participate under optional incentive regulation for its depooled traffic sensitive rates even if it remains in the NECA pool for common line rates. The Commission must also adopt earnings parameters for optional incentive regulation that reflect the considerable risks inherent in

⁸² Id.

that plan. Finally, and perhaps most importantly, the Commission must preserve prospective tariff filings for the NECA pools and other LECs that remain under rate-of-return regulation.

While the Commission need not adopt every suggestion contained in the USTA proposal on regulatory reform that was presented to the Commission's staff, USTA respectfully urges the Commission to review that proposal in light of USTA's comments herein. With regard to several issues, the NPRM is incomplete, would yield results not intended by the Commission, and/or would impose unnecessary and unreasonable burdens on small LECs.⁸³ USTA believes that elements of its proposal, as discussed in these comments, would help alleviate many of the problems apparent in the NPRM.

For all of the foregoing reasons, the Commission should modify its proposals on regulatory reform for small

⁸³ USTA is also concerned that the rules proposed in Appendix A of the NPRM are incomplete. They will need to conform with the features of the plan adopted in this proceeding.

and midsize telephone companies as set forth in these
comments.

Respectfully submitted,

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**Estimation of Historical Common Line Cost Growth
Analysis of Unseparated Loop Costs**

NECA's September 1991 Universal Service Fund (USF) Data Submission to the FCC provides an industry-wide database for an analysis of the growth in unseparated loop costs in recent years. The USF submission was used to compile loop-related revenue requirements for all reporting companies for each of the years 1986 through 1990. The growth in cost per loop for various time series was calculated for the following strata:

- Total Industry
- Price Cap Companies
- Non-Price Cap Companies

The results of this analysis are shown in tabular form in Exhibit 1 attached hereto. These figures demonstrate that the industry's growth in loop costs over the five-year period was experienced primarily by non-price cap companies. This result is explained by the fact that the non-price cap local exchange carriers (LECs) are generally smaller companies that serve more rural, less densely populated areas. Further, these companies already have largely digital networks and, thus, have fewer opportunities to implement cost savings through future digitalization of their networks.

Although the costs per loop for price cap companies were relatively stable during the study period, price cap regulation provides these companies an automatic "inflation minus X" adjustment prior to the sharing of benefits from CL demand growth. Because the optional incentive plan and Section 61.39 regulation do not have an inflation adjustment, and because the companies eligible for them have experienced the historical growth in non-traffic sensitive costs, the plans require recognition of the historical growth in common line-related costs as part of a demand sharing adjustment. It is appropriate to share the benefits of common line demand growth, but growth in common line costs per loop must also be reflected in the development of historically-based rates.

USTA's common line demand growth adjustment formula includes an annual MOU growth threshold over which common line demand growth would be shared equally between customers and carriers. This growth threshold should be equal to the experienced annual growth in loop costs per line. Based on the analysis of USF data, a reasonable measure of this parameter would be 2.5% for non-price cap companies. This figure is roughly the average of the cost growth per line experienced by the non-price cap LECs in the periods 1987-1990, 1988-1990 and 1989-1990.

Loop Cost Compound Growth Rates

	Growth Unseparated Loop Cost 86-90	Growth Unseparated Loop Cost 87-90	Growth Unseparated Loop Cost 88-90	Growth Unseparated Loop Cost 89-90
National	-0.0008%	0.0137%	0.3728%	0.4420%
Sum Price Cap Companies	-0.2031%	-0.1933%	0.1528%	0.3538%
Non-Price Cap	1.8517%	2.1823%	2.8773%	2.4300%

Source: Universal Service Data Submission, NECA, September 1991.